86 - 1201

No. .

Supreme Court, U.S.
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In the
Supreme Court of the United States.

OCTOBER TERM, 1986.

VAHLSING CHRISTINA CORPORATION,
PETITIONER,

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT.

Petition for Writ of Certiorari to the United States Court of Appeals for the First Circuit.

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Questions Presented.

I. Whether a corporation can be denied the benefit of the step transaction doctrine, which doctrine, as applied, would have allowed the corporation to disregard for federal tax purposes an exchange of stock which lacked any independent significance and which occurred as one interim transitory step in a multi-step corporate reorganization transaction, simply because that exchange of stock would otherwise disqualify the reorganization transaction from tax-free treatment?

II. Whether one step in a multi-step corporate reorganization transaction must be "necessary" to that transaction where the substance of the entire reorganization transaction reveals that the transitory step was intended as such from the outset?

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COMMISSIONER OF INTERNAL REVENUE,
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Petition for Writ of Certiorari to the United States Court of Appeals for the First Circuit.

The Petitioner, Vahlsing Christina Corporation, respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the First Circuit, which was entered in the above-entitled proceeding on July 25, 1986.[1]

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[1] *Statement Pursuant to Rule 28.1:* Vahlsing Services, Inc., Division of Greenrock, Inc., a Texas corporation, is a parent company of petitioner insofar as it directly or indirectly has power to elect a majority of petitioner's directors. Petitioner has no subsidiaries or affiliates.

Opinions Below.

The opinion of the Court of Appeals for the First Circuit has not been reported. It is reprinted in the appendix hereto at A. 1a-4a, *infra*.

The memorandum opinion of the United States Tax Court is reported as P-H Memo. T.C. ¶85,273. It is reprinted in the appendix hereto at A. 7a-25a, *infra*.

Jurisdiction.

Invoking federal jurisdiction under 26 U.S.C. § 7442, the petitioner commenced this suit in the United States Tax Court on December 3, 1973. On September 13, 1985, the Tax Court, pursuant to a memorandum opinion filed on June 6, 1985 (A. 7a-25a), entered its decision (A. 5a-6a).

On petitioner's appeal, taken pursuant to 26 U.S.C. § 7482, the United States Court of Appeals for the First Circuit on July 25, 1986, entered a judgment and an opinion affirming the Tax Court's decision (A. 1a-4a; 26a). A timely petition for rehearing was filed with the First Circuit on August 7, 1986, and was denied on August 19, 1986 (A. 27a). On November 7, 1986, Mr. Justice Brennan ordered that the time for filing this petition for writ of certiorari be extended to and including January 16, 1987 (A. 28a). The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254(1).

Statutes Involved.

Although this case does not specifically require the interpretation of any federal statute, various provisions of the Internal

Revenue Code of 1954 are tangentially involved. Those statutes include 26 U.S.C. §§ 354, 361, and 368, the pertinent parts of which are set forth in the appendix to this petition at A. 29a-30a.

Statement of the Case.

Petitioner, Vahlsing Christina Corporation (formerly The Christina Corporation), is a corporation organized under the laws of the State of Maine (A. 8a). On December 3, 1973, petitioner instituted proceedings in the United States Tax Court to contest respondent's determination of alleged income tax deficiencies which the respondent claimed were due from the petitioner for the fiscal years ending June 30, 1962, through June 30, 1967. By the time that the case was reached for trial in February 1984, all of the issues had been resolved by agreement between the parties except for two: (a) whether the petitioner received a taxable distribution in connection with one transitory step of a corporate reorganization, which step involved the transfer by petitioner of certain shares which had been specifically acquired by petitioner thirty-three (33) days earlier at the same price for which they were subsequently transferred in order to accomplish a tax-free reorganization and merger without dilution in anticipation of a public offering of stock, and (b) whether the petitioner was the recipient of personal holding company income as a result of the foregoing transaction (A. 7a-8a).

The facts pertinent to these issues, as found by the Tax Court, and as otherwise reflected in the record, may be summarized as follows.

For many years prior to 1962, the Vahlsing family was engaged, through a large number of corporations, in agricultural and related operations in Idaho, California, Texas, Maine,

New Jersey, and New York (A. 8a). These operations included not only the production of farm crops, but also the production and marketing of fertilizers and insecticides, construction work, the operation of cold storage facilities, and other endeavors. *Id.* During the fiscal years ending June 30, 1964 through June 30, 1967, the stock of these numerous corporations was owned mainly by Frederick H. Vahlsing, Sr., Josephine M. Vahlsing, his wife, or, after her death, her estate, and Frederick H. Vahlsing, Jr. *Id.*

Beginning at least as early as 1963, the Vahlsing family decided to reduce the number of their family corporations. Eventually, the number of family corporations was reduced from twenty-six (26) to five (5) (A. 9a).

Texas Plastics, Inc. (hereinafter Texas Plastics), one of the Vahlsing family corporations, was incorporated in 1944 under the laws of Texas (A. 9a). In 1962, it made an unsuccessful public offering of its stock. *Id.* The failure of this offering was due in part to the fact that it could not be accomplished without dilution of its stock (A. 38a).

After the failure of the 1962 Texas Plastics offering, the Vahlsing family members decided that a general reorganization and simplification of the Vahlsing corporations was needed and a decision was made to go forward with such a plan, *id.*, which would result in the merger of Texas Polymer Corporation (hereinafter Texas Polymer) into Texas Plastics without diluting Texas Plastics' stock. That plan encompassed six transitory steps all of which occurred in close temporal proximity (A. 19a-20a).

On July 25, 1966, Texas Plastics had only one class of stock, common voting, outstanding (A. 9a). Although it had authorized the issuance of 1,000,000 shares, it had issued only 345,583 shares at that time and they were owned as follows:

Vahlsing Foundation, Inc.[2]	5,691
Albert Pfaffenroth	2,500
Clifford Spatz	500
Margaret Schenk[3]	12,500
Petitioner	99,797-⅓
F.H. Vahlsing, Inc. (Texas)	197,000-⅔
Texas Plastics (treasury)	27,594
Total issued common stock	345,583

(A. 9a.) Disregarding the treasury shares, F.H. Vahlsing, Inc. (Texas) and petitioner thus together owned 93.33 percent of Texas Plastics' outstanding stock. *Id.* F.H. Vahlsing, Inc. (Texas), was wholly owned by petitioner during the period from June 17, 1966 through June 30, 1967. *Id.*

On July 24, 1966, the board of directors of F.H. Vahlsing, Inc. (Texas), authorized the sale to petitioner of its 197,000-⅔ shares of Texas Plastics for a total price of $677,682.29. *Id.* The resolution authorizing the sale includes the following:

> It was the opinion of the Directors that the sale of this stock to . . . [petitioner] would be a further step in consolidating the entire ownership of Texas Plastics in the hands of . . . [petitioner] and thereby a further step in simplifying the overall stock ownership of the Vahlsing companies.

(A. 10a.) The minutes on the resolution adopted July 25, 1966, authorizing petitioner's purchase of the Texas Plastics stock reflect a statement by F.H. Vahlsing, Jr., who presided at the meeting, that the purchase "was desirable in order to simplify the stock ownership of the various Vahlsing companies" and

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[2] Vahlsing Foundation, Inc. was a charitable foundation controlled by Vahlsing Family members.

[3] Margaret Schenk is the daughter of Frederick H. Vahlsing, Sr.

to eliminate "a situation where a subsidiary of The Christina Corporation [petitioner] did itself own stock of another related family company." *Id.* On July 26, 1966, the sale was completed and the shares were transferred to petitioner. *Id.* As a result of this sale, petitioner became the owner of 296,798, or 93.33 percent of Texas Plastics' outstanding stock. *Id.*

Immediately prior to July 25, 1966, Texas Plastics owned 490,000 shares and Fred H. Vahlsing, Sr., owned 35,000 shares of the total number of 525,000 shares of the issued and outstanding stock of Texas Polymer. *Id.* On July 25, 1966, Texas Plastics sold its 490,000 shares of Texas Polymer stock to petitioner for $490,000. *Id.*

On August 28, 1966, the board of directors of Texas Plastics adopted a resolution authorizing the purchase from petitioner of 122,000 shares of Texas Plastics' own stock at $3.44 per share or an aggregate amount of $419,680. *Id.* F.H. Vahlsing, Jr., who presided at the meeting, "suggested that it would be wise for the corporation [Texas Plastics] to purchase shares of its own stock to be held in the treasury of the corporation for possible future needs." *Id.* On August 29, 1966, the board of directors of petitioner authorized the sale of the 122,000 shares of Texas Plastics' stock for $3.44 per share or an aggregate of $419,680 (A. 10a-11a). On August 29, 1966, Texas Plastics paid petitioner the $419,680 (A. 11a).

As of August 29, 1966, Texas Plastics' stock was held as follows:

Vahlsing Foundation, Inc.	5,691
Albert Pfaffenroth	2,500
Clifford Spatz	500
Margaret Schenk	12,500
Petitioner	174,798
Texas Plastics (treasury)	149,594
Total issued common stock	345,583

Id. Disregarding the treasury shares, petitioner thus owned 89.19 percent of Texas Plastics' outstanding stock as of that date. *Id.*

On June 30, 1967, F.H. Vahlsing, Inc. (Texas), was merged into The Christina Corporation, and the name of the surviving corporation was Vahlsing Christina Corporation, petitioner herein. *Id.* At the time of the merger, The Christina Corporation owned all of the stock of the merged company. *Id.* The minutes of Christina on the merger include the following:

> The Chairman stated that he believed this offer was to the benefit of the corporation [F.H. Vahlsing, Inc. (Texas)] since it would result in the entire ownership of the corporation being in the hands of The Christina Corporation, and thereby a further step in simplifying the overall ownership of the Vahlsing Companies. . . .

Id.

On July 7, 1967, the board of directors of Texas Plastics voted to merge with Texas Polymer as of July 31, 1967. *Id.* On July 25, 1967, Texas Plastics, Inc.'s, stockholders approved the merger in accordance with the terms of the Plan of Merger. *Id.* On the same date, the board of directors of Texas Polymer adopted a resolution approving a plan of merger of Texas Polymer into Texas Plastics. The resolution states:

> [T]he "terms and conditions of such merger, the mode of carrying the same into effect, and the manner of exchanging the shares of stock of the corporation [Texas Polymer] for shares of stock of Texas Plastics, Inc., shall be as set forth in the proposed Plan of Merger submitted to this meeting."

(A. 11a-12a.)

On July 25, 1967, the merger was approved at a special meeting of the shareholders of Texas Plastics and at a special meeting of the shareholders of Texas Polymer (A. 12a). The plan of merger provided in pertinent part that:

> The shares of capital stock of Plastics, the surviving corporation, *issued and outstanding at the time of the merger, are not to be changed or converted as a result of the merger,* and each of said shares shall continue to be an issued and outstanding share of the capital stock of the surviving corporation.

Id. (emphasis supplied). The plan also provided that Texas Polymer's stock would be converted into stock of the surviving corporation on the basis of one share of Texas Polymer stock for .235 of a share of the surviving corporation's stock. *Id.* The merger was completed on July 31, 1967. Following the merger on July 31, 1967, the stock of Texas Plastics, the surviving corporation, was owned as follows:

Vahlsing Foundation, Inc.	5,691
Albert Pfaffenroth	2,500
Clifford Spatz	500
Margaret Schenk	12,500
Petitioner	289,948
Fred H. Vahlsing, Sr.	8,225
Texas Plastics (treasury)	26,219
Total issued common stock	345,583

Id. On August 2, 1967, petitioner purchased the remaining 26,219 shares of Texas Plastics' treasury stock from Texas Plastics for $90,193.36. *Id.*

Between October 1968, and February 1969, after the merger of Texas Plastics and Texas Polymer, and while petitioner owned 91.49% of Texas Plastics' outstanding stock, a second public offering of Texas Plastics' stock was made, which was successful, and additional capital of some $3,000,000 was raised (A. 13a).

After a trial was held on February 22 and 23, 1984, at Philadelphia, Pennsylvania, the Tax Court filed a memorandum opinion on June 6, 1985 (A. 7a-25a), and pursuant thereto a decision was entered on September 13, 1985 (A. 5a-6a). The Tax Court, disregarding the substance of the six steps which ultimately resulted in the statutory merger of Texas Polymer into Texas Plastics without dilution of Texas Plastics' stock, ruled, *inter alia,* that petitioner's transfer of 122,000 shares of Texas Plastics stock to Texas Plastics in exchange for $419,680 on August 29, 1966, constituted a separate taxable transaction which resulted in an alleged deficiency in income tax due from the petitioner for the taxable year ended June 30, 1967, in the amount of $298,364.58 (A. 13a-25a).

Petitioner filed a timely Notice of Appeal in the United States Court of Appeals for the First Circuit. On July 25, 1986, the First Circuit entered a judgment and an opinion which affirmed the Tax Court's decision (A. 1a-4a; 26a). The First Circuit ruled that although it questioned the Tax Court's finding that petitioner's transfer to Texas Plastics of the 122,000 shares of Texas Plastics stock was not a "necessary" step in the Texas Plastics reorganization (A. 2a n.1), that transfer and exchange still could not be disregarded under the step transaction doctrine because the exchange of stock was for cash, and as such the transfer fell outside the nonrecognition of gain rule set forth in 26 U.S.C. § 354(a)(1) (A. 2a-4a).

Reasons for Granting the Writ.

I. THE FIRST CIRCUIT HAS EVISCERATED THE STEP TRANSACTION DOCTRINE BEYOND ANY LIMITATION IMPOSED BY THIS COURT OR ANY CIRCUIT COURT OF APPEALS BY HOLDING THAT THE DOCTRINE MAY NOT BE APPLIED TO A TRANSITORY STEP IN A PLANNED MULTI-STEP TAX-FREE CORPORATE REORGANIZATION TRANSACTION IF THE TRANSITORY INTERIM STEP WOULD OTHERWISE DISQUALIFY THE REORGANIZATION TRANSACTION FROM TAX-FREE TREATMENT.

The First Circuit has adopted a view of the step transaction doctrine which is at odds with all prior holdings of this Court and the Courts of Appeals. In this case the First Circuit, without citing any precedent to support its holding, ruled that even if the exchange of stock at issue was an interim transitory step in a reorganization transaction, and could therefore be disregarded for federal tax purposes pursuant to the step-transaction doctrine, that doctrine could not be applied where the transitory step would disqualify the reorganization transition from tax-free treatment. Such an evisceration of the step transaction doctrine deserves this Court's attention.

Step transaction analysis has traditionally been available in the area of corporate reorganizations to look through the form of a transaction in order to discover its substance or reality. See, e.g., *Weiss* v. *Stearn, Commissioner,* 265 U.S. 242, 254 (1924); *Helvering* v. *Alabama Asphaltic Limestone Co.,* 315 U.S. 179, 184-185 (1942); *McDonald's Restaurants of Illinois, Inc.* v. *Commissioner,* 688 F.2d 520, 524-525 (7th Cir. 1982); *King Enterprises, Inc.* v. *United States,* 418 F.2d 511, 516-518 (Ct. Cl. 1969); *Louis W. Gunby, Inc.* v. *Helvering,* 122 F.2d 203, 205 (D.C. Cir. 1941); *Thurber* v. *Commissioner,* 84 F.2d 815, 818 (1st Cir. 1936); see generally, Mintz & Plumb, *Step*

Transactions in Corporate Reorganizations, 12 INST. ON FED. TAX'N. 247 (1954) (hereinafter Mintz & Plumb). Thus it has been held that "[t]ransitory phases of an arrangement frequently are disregarded under . . . the revenue acts where they add nothing of substance to the completed affair," *Helvering* v. *Alabama Asphaltic Limestone Co.*, 315 U.S. 179, 184-185 (1942), and that "separate steps must be taken together in attaching tax consequences if that combination is the substance of the transaction." *Glacier State Electric Supply Co.* v. *Commissioner,* 80 T.C. 1047, 1054 (1983).

The essence of the step transaction doctrine as applied in the context of corporate reorganizations, is that an intermediate transitory step of no independent significance, apart from its role in the overall reorganization transaction, will be disregarded for federal tax purposes, even where that transitory step, if it occurred outside of the reorganization transaction, would ordinarily result in the imposition of a tax. *Helvering* v. *Alabama Asphaltic Limestone Co.*, 315 U.S. 179, 184-185 (1942); see also Rev. Rul. 83-142, 1983-2 C.B. 68, 69; Rev. Rul. 78-397, 1978-2 C.B. 150, 151; Mintz & Plumb, *supra* at 247.

In this case, however, the First Circuit took an entirely different view of the step transaction doctrine, where it held:

> It is appellant's contention that because the . . . [transitory step] in question took place as one step in a reorganization of Texas Plastics, any gain from the . . . [transitory step] is tax-free under 26 U.S.C. § 354. Unfortunately for appellant, whether or not the redemption was a necessary step in a reorganization of Texas Plastics, the income realized from that . . . [transitory step] cannot be considered tax-free. Section 354 limits the nonrecognition of gain arising from reorganizations to exchanges of stock or securi-

> ties for other stock or securities. It does not extend to exchanges of stock for cash.

(A. 2a) (footnote omitted).

The First Circuit's ruling in this case has effectively turned the step transaction doctrine on its head by holding that the doctrine is to be applied not with reference to whether the subject step is a transitory interim component of an overall scheme, but rather with reference to whether the interim transitory step, which is of no independent significance, would otherwise disqualify the overall reorganization transaction from tax-free treatment. This holding is entirely inconsistent with all prior judicial interpretations of the doctrine, as well as the application of the doctrine by the Internal Revenue Service itself, all of which permit *otherwise taxable interim steps* to be disregarded as non-taxable transitory exchanges which have occurred as components of integrated transactions. See, e.g., *Helvering* v. *Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942) (transfer of assets by creditor's committee as constituting a break in continuity of interest); *McDonald's Restaurants of Illinois, Inc.* v. *Commissioner*, 688 F.2d 320 (7th Cir. 1982) (post-merger transfer of stock); *King Enterprises, Inc.* v. *United States*, 418 F.2d 511 (Ct. Cl. 1969) (pre-merger transfer of stock for stock, cash and notes). Rev. Rul. 83-142, 1983-2 C.B. 68, 69 (payment of cash which would otherwise constitute payment of a dividend, within corporate reorganization, deemed "a transitory step that has no federal income tax consequences"); Rev. Rul. 78-397, 1978-2 C.B. 150, 151 (exchange of stock for cash which would otherwise constitute redemption of shares disregarded and deemed to have no federal income tax consequence).

Thus, if the Court of Appeals' ruling in this case is allowed to stand, it would effectively abolish the application of the

step transaction doctrine in the context of corporate reorganizations in the First Circuit. This would be a result totally at odds with the holdings of this Court as well as the holdings of the other Circuit Courts of Appeals.

II. By Imposing a Requirement That Each Transitory Step in a Multi-Step Corporate Reorganization Transaction, When Viewed Alone, Must Be Deemed "Necessary" to That Reorganization Transaction in Order to Qualify for Step Transaction Analysis, the First Circuit Has Adopted a Test Which Conflicts with Less Rigorous Tests Employed by Other Federal Appellate Courts in Similar Cases.

Although the First Circuit did not reach the merits of this controversy due to the court's erroneous conclusion that step transaction analysis could not be performed, the court nonetheless articulated a standard of review which it would have applied in this case that is not consistent with standards of review adopted by other federal appellate courts for cases of this nature.

While it has long been recognized that there is no "single universal test" for the application of the step transaction doctrine, Mintz & Plumb, *supra* at 252-253, certain tests have been formulated by the courts to be applied in particular factual contexts. *See generally, McDonald's Restaurants of Illinois, Inc.* v. *Commissioner,* 688 F.2d 520, 524-525 (7th Cir. 1982); *King Enterprises, Inc.* v. *United States,* 418 F.2d 511, 516-519 (Ct. Cl. 1969); Mintz & Plumb, *supra* at 249-253.

In this case the First Circuit held that in order to qualify for step transaction analysis the transitory step at issue would have to be "necessary" to the overall reorganization transaction. While petitioner does not maintain that the transfer by petitioner

of 122,000 shares of Texas Plastics stock to Texas Plastics was not necessary to the overall goal of merging Texas Polymer and Texas Plastics without dilution of Texas Plastics' stock, the standard of "necessity" articulated by the First Circuit is overly restrictive for this type of case. The First Circuit's "necessity" test appears to be akin to the "binding commitment" test articulated by this Court in *Commissioner* v. *Gordon*, 391 U.S. 83, 96 (1968), where it was held that in order for a particular step which occurred as part of an indeterminate and unfixed transaction to be deemed an interim transitory step of no independent significance, there had to be a "binding commitment" to take the later steps.

The binding commitment test, however, was "formulated to deal with the characterization of a transaction that in fact spanned several tax years and could have remained 'not only indeterminable but unfixed for an indefinite and unlimited period in the future, awaiting events that might or might not happen.' " *McDonald's Restaurants of Illinois, Inc.* v. *Commissioner*, 688 F.2d 520, 525 (7th Cir. 1982), quoting *Commissioner* v. *Gordon*, 391 U.S. 83, 96 (1968).

The strictures of the *Gordon* "binding commitment" test have since been viewed as being restricted to transactions spanning indefinite and unlimited periods of time, see, e.g., *King Enterprises, Inc.* v. *United States*, 418 F.2d 511, 518 (Ct. Cl. 1969), and the test itself has been criticized as being an anathema to the underlying purpose of the step transaction doctrine that permits substance to prevail over form. *Id.*

The First Circuit should not be permitted to adopt, and upon remand, if its judgment is reversed, should not be allowed to apply a "necessity" or "binding commitment" test in the context of a reorganization case such as this in which the transitory steps at issue and the ultimate reorganization merger occurred within the same fiscal year. Application of step transaction analysis in the area of tax-free corporate reorganizations has traditionally turned not on binding commitments or inter-

dependence of one step to another, but rather on the intention of the parties and the end result which they achieved. Mintz & Plumb, *supra* at 273-274.

Other federal appellate courts have rejected the application of the binding commitment test in step transaction cases, either on the ground that the temporal proximity of the various steps did not implicate the concerns of this Court in *Gordon*, see, e.g., *McDonald's Restaurants of Illinois, Inc.* v. *Commissioner*, 688 F.2d 520, 525 (7th Cir. 1982), or because such a test, if applied in all cases, would result in the emasculation of the doctrine. *King Enterprises, Inc.* v. *United States*, 418 F.2d 511, 518 (Ct. Cl. 1969). The Court of Claims in *King Enterprises* stated this concern succinctly:

> Clearly, the step transaction doctrine would be a dead letter if restricted to situations where the parties were *bound* to take certain steps.
>
> The doctrine derives vitality, rather, from its application where the form of a transaction *does not require* a particular further step be taken; but, once taken, the substance of the transaction reveals that the ultimate result was intended from the outset.

King Enterprises, Inc. v. *United States*, 418 F.2d 511, 518 (Ct. Cl. 1969) (emphasis in original).

Accordingly, this Court should not allow the First Circuit to establish a test more restrictive than that enunciated by the Court of Claims in *King Enterprises*, in cases such as this where the reorganization transaction resulting in the merger of Texas Polymer into Texas Plastics without dilution of Texas Plastics' stock was intended from the outset, and where the transitory steps all occurred in close temporal proximity (A. 19a-20a).

Conclusion.

For these various reasons, the petition for certiorari should be granted.

Respectfully submitted,

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January 16, 1987

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Appendix A.

United States Court of Appeals
For the First Circuit

No. 85-1988

VAHLSING CHRISTINA CORPORATION,
(Formerly THE CHRISTINA CORPORATION),
Petitioner, Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent, Appellee.

ON APPEAL FROM A DECISION OF THE
UNITED STATES TAX COURT
[Hon. C. Moxley Featherston, *Senior Judge*]

Before
Campbell, *Chief Judge*,
Coffin and Bownes, *Circuit Judges*.

Frederick H. Vahlsing, Jr., President, Vahlsing Christina Corporation, and *Bruce S. Billings*, Vice President, Vahlising Christina Corporation, on brief, pro se.

Michael L. Paup, Richard Farber, Gayle P. Miller, Tax Division, Department of Justice, and *Roger M. Olsen*, Acting Assistant Attorney General, on brief for appellee.

July 25, 1986

BOWNES, *Circuit Judge*. We review a decision by the Tax Court holding appellant Vahlsing Christina Corporation (Christina) liable for $298,364.58 in past due personal holding company taxes for the taxable year ending June 30, 1967. We find the Tax Court's analysis correct and affirm.

The Tax Court found that the redemption by Texas Plastics, Inc., of 122,000 shares of Texas Plastics stock owned by Christina for $419,680 was essentially equivalent to a dividend and gave rise to substantial dividend income on the part of Christina. Christina was, theefore, found to be a personal holding company, which is defined as a controlled corporation that has accumulated at least 60% of its income from dividends, interest, royalties and other "passive" income. 26 U.S.C. § 543(a). This subjected Christina to the personal holding company tax in addition to the normal corporate income tax.

It is appellant's contention that because the redemption in question took place as one step in a reorganization of Texas Plastics, any gain from the redemption is tax-free under 26 U.S.C. § 354. Unfortunately for appellant, whether or not the redemption was a necessary step in a reorganization of Texas Plastics,[1] the income realized from that redemption cannot be considered tax-free. Section 354 limits the nonrecognition of gain arising from reorganizations to exchanges of stock or securities for other stock or securities. It does not extend to exchanges of stock for cash.

Appellant argues that, although in isolation the redemption appeared to be an exchange of stock for cash, when viewed in the context of other steps involved in the reorganization of Texas Plastics, the redemption was actually an exchange of stock in Texas Plastics for stock in Texas Polymer, a company

[1] The Tax Court found that the redemption of the Plastics stock was not a necessary step in the Plastics reorganization. We have some questions about this finding, but since appellant would not prevail even if the redemption were found necessary to the reorganization, we need not address this issue.

that was to merge with Texas Plastics as part of the reorganization plan. In order to understand this argument, we must set out a little of the factual background. Christina, Texas Plastics and Texas Polymer were all privately held corporations controlled by the Vahlsing family. As part of a program of simplification and reorganization involving these and twenty-odd other Vahlsing family corporations, Christina was to have consolidated control over a merged Texas Plastics and Texas Polymer. The merged corporation, called Texas Plastics, would then go public to raise capital for modernizing its plant. The crucial steps in this plan were as follows:

1. Christina bought 490,000 shares of Texas Polymer stock from Texas Plastics for $490,000;

2. Texas Plastics bought 122,000 shares of its own stock from Christina for $419,680;

3. Texas Polymer merged into Texas Plastics. Texas Polymer stock was converted into Texas Plastics stock at a conversion ratio of .235 shares of Plastics for each share of Polymer. Therefore, Christina received 115,150 shares of Plastics for its 490,000 shares of Polymer.

The net effect of steps 1 and 2, according to appellant, was a swap by Texas Plastics of something less than 490,000 shares of Polymer stock for 122,000 shares of Plastics stock. The mediation of this exchange by the use of cash payments was designed to provide evidence of an arms-length and fair exchange when the time came to make the public offering.

Appellant has not directed us to any cases, nor have we found any, which would allow the elevation of substance over form with regard to steps 1 and 2. We must, therefore, follow the basic principle that

> while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so he must accept the tax consequences of his choice . . . and

> may not enjoy the benefit of some other route he might have chosen to follow but did not.

Commissioner v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974).

Section 354 clearly requires a stock-for-stock exchange in order for a corporation to qualify for nonrecognition of gains. Appellant chose to exchange the stock for cash rather than other stock and must accept the consequences of that choice.

Affirmed.

UNITED STATES TAX COURT

VAHLSING CHRISTINA CORPORATION (FORMERLY THE CHRISTINA CORPORATION)	)	
Petitioner,	)	
v.	)	Docket No. 8571-73
COMMISSIONER OF INTERNAL REVENUE,	)	
Respondent.	)	

DECISION

Pursuant to the opinion of the Court filed on June 6, 1985, and incorporating herein the facts recited in the respondent's computation as the findings of the Court it is,

ORDERED and DECIDED: That there is an overpayment in income tax and an overpayment in the addition to tax under I.R.C. § 6651(a) due to the petitioner for the taxable year ended June 30, 1963 in the amounts of $1644.76, and $42.95, respectively, which amounts were paid on November 4, 1963, and for which amount a claim for refund could have been filed, under the provisions of I.R.C. § 6511(c), on September 10, 1973, the date of the mailing of the notice of deficiency;

That there is a deficiency in income tax due from the petitioner for the taxable year ended June 30, 1964 in the amount of $5971.02;

That there is no addition to tax due from petitioner for the taxable year ended June 30, 1964 under the provisions of I.R.C. § 6651(a);

That there is no deficiency in income tax due from, or overpayment due to, the petitioner for the taxable year ended June 30, 1965;

That there is an overpayment in income tax due to the petitioner for the taxable year ended June 30, 1966 in the amount of $1,298.98, which amount was paid: $600.00 on September 15, 1966 and $698.98 on October 24, 1966; and for which amount a claim for refund could have been filed, under the provisions of I.R.C. § 6511(c), on September 10, 1973, the date of the mailing of the notice of deficiency; and

That there is a deficiency in income tax due from petitioner for the taxable year ended June 30, 1967 in the amount of $298,364.58, which amount is solely attributable to the personal holding company tax imposed under I.R.C. § 541.

(Signed) C. MOXLEY FEATHERSTON
Judge.

Entered: Sep 13 1985

Appendix C.

T. C. Memo. 1985-273

UNITED STATES TAX COURT

VAHLSING CHRISTINA CORPORATION, FORMERLY THE CHRISTINA CORPORATION, Petitioner *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 8571-73. Filed June 6, 1985.

Roy S. Kaneda, for the petitioner.
Eugene J. Wien, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

FEATHERSTON, *Judge*: Respondent determined the following deficiencies in petitioner's Federal income taxes and additions to tax for the fiscal years ended June 30, 1963 through June 30, 1967:

Taxable Year Ended	Deficiency	Addition Sec. 6651(a), I.R.C. 1954
June 30, 1963	$ 1,360.04	$ 136.00
June 30, 1964	$ 17,225.22	$1,722.53
June 30, 1965	$233,691.68	$ -0-
June 30, 1966	$217,388.52	$ -0-
June 30, 1967	$561,489.17	$ -0-

The petition as filed raised a multitude of issues. All of them have been settled by agreement except two:

1. Whether the transfer by petitioner of 122,000 shares of Texas Plastics, Inc., stock to Texas Plastics, Inc., on August 29, 1966, in exchange for $419,680 was a redemption of stock "essentially equivalent to a dividend" within the meaning of section 302(b)(1)[1] and thus taxable to petitioner under section 301.

2. Whether petitioner is liable for the personal holding company tax under section 541 equal to 70 percent of its undistributed personal holding company income for the taxable year ended June 30, 1967.

FINDINGS OF FACT

Vahlsing Christina Corporation (formerly The Christina Corp.) is a corporation organized under the laws of Maine. It filed its Federal income tax returns for the taxable year ended June 30, 1963, with the District Director for Manhattan, New York, and for the other years in dispute with the District Director for Newark, New Jersey.

For many years prior to 1962, the Vahlsing family was engaged, through a large number of corporations, in far-flung agricultural and related operations in Idaho, California, Texas, Maine, New Jersey, and New York. These operations included not only the production of farm crops but also the production and marketing of fertilizers and insecticides, construction work, cold storage facilities, and other endeavors. During the fiscal years June 30, 1964 through June 30, 1967, the stock of these numerous corporations was owned mainly by Fred H. Vahlsing, Sr., Josephine M. Vahlsing, his wife, or, after her death, her estate, and Fred H. Vahlsing, Jr.

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[1] All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise noted.

Beginning at least as early as 1963, the Vahlsing family decided to reduce the number of their family corporations. Eventually, the number of family corporations was reduced from 26 to four or five.

Texas Plastics, Inc. (hereinafter Texas Plastics), one of the Vahlsing family corporations, was incorporated in 1944 under the laws of Texas. In 1962, it made an unsuccessful public offering of its stock. On July 25, 1966, Texas Plastics had only one class of stock, common voting, outstanding. Although it had authorized the issuance of 1,000,000 shares, it had issued only 345,583 shares at that time and they were owned as follows:

Vahlsing Foundation, Inc.[1]	5,691
Albert Pfaffenroth	2,500
Clifford Spatz	500
Margaret Schenk[1]	12,500
Petitioner	99,797-⅓
F. H. Vahlsing, Inc. (Texas)	197,000-⅔
Texas Plastics (treasury)	27,594
Total issued common stock	345,583

[1] Vahlsing Foundation, Inc., was a charitable foundation controlled by Vahlsing family members. Margaret Schenk is the daughter of F. H. Vahlsing, Sr.

Disregarding the treasury shares, F. H. Vahlsing, Inc. (Texas) and petitioner thus together owned 93.33 percent of Texas Plastics' outstanding stock. F. H. Vahlsing, Inc. (Texas), was wholly owned by petitioner during the period from June 17, 1966 through June 30, 1967.

On July 24, 1966, the board of directors of F.H. Vahlsing, Inc. (Texas), authorized the sale to petitioner of its 197,000-⅔ shares of Texas Plastics for a total price of $677,682.29. The resolution authorizing the sale includes the following:

> It was the opinion of the Directors that the sale of this stock to * * * [petitioner] would be a further step in consolidating the entire ownership of Texas Plastics in the hands of * * * [petitioner] and thereby a further step in simplifying the overall stock ownership of the Vahlsing companies.

The minutes on the resolution adopted July 25, 1966, authorizing petitioner's purchase of the Texas Plastics stock reflect a statement by F. H. Vahlsing, Jr., who presided at the meeting, that the purchase "was desirable in order to simplify the stock ownership of the various Vahlsing companies" and to eliminate "a situation where a subsidiary of The Christina Corporation [petitioner] did itself own stock of another related family company." On July 26, 1966, the sale was completed and the shares were transferred to petitioner. As a result of this sale, petitioner became the owner of 296,798, or 93.33 percent of Texas Plastics' outstanding stock.

Immediately prior to July 25, 1966, Texas Plastics owned 490,000 shares and Fred H. Vahlsing, Sr., owned 35,000 shares of the total number of 525,000 shares of the issued and outstanding stock of Texas Polymer Corp. (hereinafter Texas Polymer). On July 25, 1966, Texas Plastics sold its 490,000 shares of Texas Polymer stock to petitioner for $490,000.

On August 28, 1966, the board of directors of Texas Plastics adopted a resolution authorizing the purchase from petitioner of 122,000 shares of Texas Plastics' own stock at $3.44 per share or an aggregate amount of $419,680. F. H. Vahlsing, Jr., who presided at the meeting, "suggested that it would be wise for the corporation [Plastics] to purchase shares of its own stock to be held in the treasury of the corporation for possible future needs." On August 29, 1966, the board of directors of petitioner authorized the sale of the 122,000 shares of Texas Plastics' stock for $3.44 per share or an aggregate

of $419,680. On August 29, 1966, Texas Plastics paid petitioner the $419,680.

As of August 29, 1966, Texas Plastics' stock was held as follows:

Vahlsing Foundation, Inc.	5,691
Albert Pfaffenroth	2,500
Clifford Spatz	500
Margaret Schenk	12,500
Petitioner	174,798
Plastics (treasury)	149,594
Total issued common stock	345,583

Disregarding the treasury shares, petitioner thus owned 89.19 percent of Texas Plastics' outstanding stock as of that date.

On June 30, 1967, F. H. Vahlsing, Inc. (Texas), was merged into The Christina Corp., and the name of the surviving corporation was Vahlsing Christina Corp., petitioner herein. At the time of the merger, The Christina Corp. owned all of the stock of the merged company. The minutes of Christina on the merger include the following:

> The Chairman stated that he believed this offer was to benefit of the corporation since it would result in the entire ownership of the corporation being in the hands of The Christina Corporation, and thereby a further step in simplifying the overall ownership of the Vahlsing companies.* * *

On July 7, 1967, the board of directors of Texas Plastics voted to merge with Texas Polymer as of July 31, 1967. On July 25, 1967, Texas Plastics, Inc.'s, stockholders approved the merger in accordance with the terms of the Plan of Merger. On the same date, the board of directors of Texas Polymer

adopted a resolution approving a plan of merger of Texas Polymer into Texas Plastics. The resolution states that —

> the "terms and conditions of such merger, the mode of carrying the same into effect, and the manner of exchanging the shares of stock of the corporation [Texas Polymer] for shares of stock of Texas Plastics, Inc., shall be as set forth in the proposed Plan of Merger submitted to this meeting."

On July 25, 1967, the merger was approved at a special meeting of the shareholders of Texas Plastics and at a special meeting of the shareholders of Texas Polymer. The plan of merger provided that Texas Plastics' outstanding stock would not "be changed or converted as a result of the merger" and would continue to be issued and outstanding stock of the surviving corporation. Texas Polymer's stock would be converted into stock of the surviving corporation on the basis of one share of Texas Polymer stock for .235 of a share of the surviving corporation's stock. The merger was completed on July 31, 1967. Following the merger on July 31, 1967, the stock of Texas Plastics, the surviving corporation, was owned as follows:

Vahlsing Foundation, Inc.	5,691
Albert Pfaffenroth	2,500
Clifford Spatz	500
Margaret Schenk	12,500
Petitioner	289,948
Fred H. Vahlsing, Sr.	8,225
Plastics (treasury)	26,219
Total issued common stock	345,583

On August 2, 1967, petitioner purchased the remaining 26,219 shares of Texas Plastics' treasury stock from Texas Plastics for $90,193.36.

Between October 1968 and February 1969, a second public offering of Texas Plastics' stock was made and additional capital of some $3,000,000 was raised.

OPINION

At issue is whether petitioner's transfer on August 29, 1966, of 122,000 shares of Texas Plastics stock to Texas Plastics in exchange for $419,680 was a redemption of stock "essentially equivalent to a dividend" within the meaning of section 302(b)(1), and thus taxable to petitioner as ordinary dividend income under sections 302(d) and 301(c) as determined by respondent; or whether the transaction should be considered merely one transitory, nontaxable step as part of the statutory merger between Texas Plastics and Texas Polymer qualifying as a tax-free reorganization under section 368(a)(1)(A), as urged by petitioner.

Our conclusion with respect to the taxability of this transaction will determine whether petitioner is liable for the personal holding company tax under section 541. For the reasons discussed below, we sustain respondent's determinations that petitioner is taxable with ordinary dividend income on the transaction at issue and that petitioner is liable for the personal holding company tax under section 541.

Section 317(b) provides that "stock shall be treated as redeemed by a corporation if the corporation acquires its stock * * * in exchange for property." Under section 317(a), the term "property" includes money.[2] Respondent contends that

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[2] SEC. 317. OTHER DEFINITIONS.

(a) Property. — For purposes of this part, the term "property" means money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock).

(footnote continued)

because Texas Plastics acquired 122,000 shares of its stock in exchange for the $419,680 payment to petitioner, such transaction should be treated as a redemption.

The tax consequences of a redemption of stock are governed by section 302.[3] Subsection (a) of that section, as in effect for 1967, the year in which the transaction at issue took place, provides that a stock redemption shall be treated as an exchange, and thus eligible for capital gains rather than ordinary income treatment, if it falls into any one of the four following categories: (1) a redemption that is "not essentially equivalent to a dividend" under section 302(b)(1); (2) a "substantially disproportionate" redemption under section 302(b)(2); (3) a

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(b) Redemption of Stock. — For purposes of this part, stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock.

[3] SEC. 302. DISTRIBUTIONS IN REDEMPTION OF STOCK.

(a) General Rule. — If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), or (3) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) Redemptions Treated as Exchanges. —

(1) Redemptions not equivalent to dividends. — Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

(2) Substantially disproportionate redemption of stock. —

* * *

(3) Termination of shareholder's interest. — Subsection (a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.

* * *

(d) Redemptions Treated as Distributions of Property. — Except as otherwise provided in this sub-chapter, if a corporation redeems its stock (within the meaning of section 317(b)), and if subsection (a) of this section does not apply, such redemption shall be treated as a distribution of property to which section 301 applies.

redemption of all of the shareholder's stock under section 302(b)(3); and (4) a redemption of the stock of certain railroad corporations under section 302(b)(4).

Neither party argues that Texas Plastics' redemption of 122,000 shares of its stock from petitioner in exchange for a $419,680 cash payment on August 29, 1966, falls within categories (2), (3), or (4). The issue is with respect to category (1): Whether the redemption payment by Texas Plastics to petitioner was "essentially equivalent to a dividend."

Whether a distribution is essentially equivalent to a dividend under section 302(b)(1) "depends upon the facts and circumstances of each case." Sec. 1.302-2(b), Income Tax Regs. To qualify for capital gain treatment under section 302(a), the redemption under section 302(b)(1) "must result in a meaningful reduction of the shareholder's proportionate interest." *United States* v. *Davis*, 397 U.S. 301, 313 (1970); *Metzger Trust* v. *Commissioner*, 693 F.2d 459, 467 (5th Cir. 1982), affg. 76 T.C. 42 (1981); *Coates Trust* v. *Commissioner*, 480 F.2d 468, 474 (9th Cir. 1973), affg. 55 T.C. 501 (1970).

As disclosed in our findings, prior to the redemption of the 122,000 shares of Texas Plastics stock, petitioner, on August 29, 1966, held 296,798, or 93.33 percent, of the 317,989 outstanding shares of Texas Plastics. After the redemption, petitioner, on August 29, 1966, held 174,798, or 89.19 percent, of the 195,989 shares that remained outstanding. This small decrease in petitioner's stock holding could not properly be described as "meaningful reduction." Petitioner's control of Texas Plastics was unaltered. *Friend* v. *United States*, 345 F.2d 761, 764 (1st Cir. 1965); *Benjamin* v. *Commissioner*, 66 T.C. 1084, 1108-1109 (1976), affd. 592 F.2d 1259 (5th Cir. 1979); *Niedermeyer* v. *Commissioner*, 62 T.C. 280, 287 (1974), affd. 535 F.2d 500 (9th Cir. 1976). Nor did the redemption effect any change in the relationship among Texas Plastics shareholders. See *Himmel* v. *Commissioner*, 338 F.2d 815,

817 (2d Cir. 1964), revg. 41 T.C. 62 (1963). We conclude, therefore, that when analyzed under section 302(b)(1), the redemption was essentially equivalent to a dividend to petitioner.

Petitioner argues that a dividend was not intended. Section 302(d), however, provides that if a corporation redeems its stock and if, as we have concluded above, section 302(a) is inapplicable, "such redemption shall be treated as a distribution of property to which section 301 applies." Section 301(a)[4] provides that a distribution of "property," which includes money under section 317(a), "made by a coporation [Texas Plastics] to a shareholder [petitioner] with respect to its stock" shall be treated as a dividend to the extent of the corporation's earnings and profits. The parties here agree that Texas Plastics had sufficient earnings and profits to support dividend treatment of the full amount of the $419,680. Treatment of that amount as a dividend is, therefore, required by the statute.

Section 316(a),[5] which defines the term "dividend," does not require that a corporation intend to pay a dividend or that a

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[4] SEC. 301. DISTRIBUTIONS OF PROPERTY.

(a) In General. — Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

* * *

(c) Amount Taxable. — In the case of a distribution to which subsection (a) applies —

(1) Amount constituting dividend. — That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

* * *

[5] SEC. 316. DIVIDEND DEFINED.

(a) General Rule. — For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders —

(footnote continued)

shareholder intend that the money he receives be a dividend. Rather, the section specifies that a dividend is "any distribution of property made by a corporation to its shareholders * * * out of earnings and profits." That was the source of the $419,680 distribution in this case. It was, therefore, a dividend.

Petitioner further argue that it would be wholly illogical to conclude that Texas Plastics' payment of $419,680 to petitioner for the 122,000 shares of stock was the payment of a dividend. Texas Plastics at that time was, in fact, trying to raise capital by arranging its affairs for a public offering of its stock and would not, in those circumstances, have intended to pay a dividend.

In presenting this argument, petitioner misconceives the effect of section 302(b)(1). Whether Texas Plastics had the payment of a dividend as its "sole purpose" in redeeming some of the shares owned by petitioner is not the test for the application of the dividend equivalence test. Indeed, the Supreme Court in *United States* v. *Davis*, 397 U.S. 301, 312 (1970), declared that the "'business purpose of a transaction is irrelevant in determining dividend equivalence' under section 302(b)(1)." See also *Rose Ann Coates Trust* v. *Commissioner*, 55

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(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

T.C. 501, 514 (1970), affd. sub nom. *Coates Trust* v. *Commissioner*, 480 F.2d 468 (9th Cir. 1973); *Estate of Runnels* v. *Commissioner*, 54 T.C. 762, 765 (1970). As stated in *Metzger Trust* v. *Commissioner*, 693 F.2d 459, 464 (5th Cir. 1982), affg. 76 T.C. 42 (1981):

> *Davis* teaches that in applying the "essentially equivalent to a dividend" test * * *, if the resulting structure has virtually the same incidents of ownership the corporate payments distribute earnings despite an indisputable contrary business purpose.

As we have discussed above, no significant change in the ownership of Texas Plastics occurred as a result of the redemption of the 122,000 shares of its stock from petitioner. The transaction's effect, although perhaps not intended as such, was nevertheless substantially equivalent to a dividend, and taxable as ordinary income.[6]

Petitioner's principal argument, however, is that petitioner's exchange of Texas Plastics stock for the $419,680 payment was only one transitory step in a series of six interdependent steps culminating in a single transaction, i.e., the statutory merger of Texas Polymer into Texas Plastics, and that, because the six steps resulted in a tax-free reorganization under section 368(a)(1)(A)[7], no gain or loss is to be recognized as a result of the transaction here in issue. According to petitioner, the objective of the six-step process was to arrange Texas Plastics' ownership so that, when the surviving corporation's stock was

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[6] In the notice of deficiency, respondent allowed petitioner the 85-percent dividends-received deduction under sec. 243(a)(1).

[7] At trial, petitioner's emphasis was placed almost exclusively on the theory that the overall transaction was a recapitalization under sec. 368(a)(1)(E). In petitioner's brief in reply, petitioner concedes that the transaction here in issue was not a sec. 368(a)(1)(E) reorganization.

eventually sold to the public, there would be little or no dilution in petitioner's majority control. The merger was also a part of an overall plan to simplify the organization and ownership of the many and far-flung Vahlsing family corporations.[8] Petitioner briefs the issue presented on the apparent understanding that the term "reorganization" as used in the Code is broad enough to include as a single reorganization the several mergers, consolidations, realignments, and readjustment of the large group of Vahlsing family corporations into four or five corporations, as well as a variety of related transactions.

As petitioner presents its case, the six steps in the merger of Texas Polymer into Texas Plastics were as follows:

1. On April 20, 1966, Texas Polymer issued 490,000 shares of its stock to Texas Plastics as part of the consideration for property known as the Mathis Plant.

2. On July 25, 1966, petitioner purchased from Texas Plastics the 490,000 shares of Texas Polymer stock for $490,000.

3. On July 22, 1966, petitioner also purchased 197,000-⅔ shares of Texas Plastics from F. H. Vahlsing (Texas) for $3.44 per share or an aggregate amount of $677,682.29, thus bringing

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[8] At one point in the trial, respondent's counsel raised a question as to the use by witness Fred H. Vahlsing, Jr., of the word "reorganization," and the Court stated:

> If I understand his testimony [that of Fred H. Vahlsing, Jr.], it is, that he looks at a broad picture of all of the corporations owned by the Vahlsing Family. The grand design is to eliminate as many corporations as possible and end up with 4 or 5 corporations, which is ultimately what they did. As I understand it, that is what he refers to as the plan of reorganization * * * is that correct?

Mr. Vahlsing answered "yes," and petitioner reiterates that position. On brief, petitioner states that Mr. Vahlsing used the words "plan of reorganization" as an ordinary layman would and identifies F. H. Vahlsing, Inc. (Texas), and F. H. Vahlsing, Sr., who owned some of Texas Polymer's stock, as well as Texas Plastics and Texas Polymer, as parties to the reorganization.

petitioner's control of Texas Plastics' stock to 93.33 percent, as detailed in our findings.

4. On August 29, 1966, the transaction directly in issue occurred. Texas Plastics acquired 122,000 shares of its own stock from petitioner for an aggregate amount of $419,680, to be held "in the treasury of the corporation for future possible needs."

5. On July 31, 1967, Texas Polymer was merged into Texas Plastics.

6. On August 2, 1967, petitioner purchased the remaining 26,219 shares of Texas Plastics treasury stock for the book value of $3.44 per share or a total of $90,193.36. As of the final step, petitioner owned 91.48 percent of Texas Plastics' 345,583 issued shares.

Petitioner's brief states:

> Since Texas Plastics, Inc. only had 27,594 shares of treasury stock on hand to effect the merger, it temporarily acquired the 122,000 shares of treasury stock on August 29, 1966 in step four to effect the merger in step five with "no dilution."
>
> As a result of step five, the transitory exchange transactions were completed and closed. The 490,000 and 25,000 shares of Texas Polymer Corporation stock temporarily acquired in step one and step two plus the 10,000 shares originally owned by F. H. Vahlsing, Sr. were exchanged for 123,375 shares of Texas Plastics, Inc. treasury stock of which 122,000 shares were temporarily acquired in step four. * * *
>
> Step four is not essentially equivalent to a dividend and it does not constitute "boot" in a plan of reorganization because step four was essentially an exchange transaction and *The Christina Corporation* [*petitioner*] *had placed $160,512.26 more in the*

hands of Texas Plastics, Inc. than The Christina Corporation took back as a result of steps two, four, five and six in order to accomplish the merger of Texas Polymer Corporation into Texas Plastics, Inc. with "no dilution."

Petitioner adds:

> The merger of Texas Polymer Corporation into Texas Plastics, Inc. under the facts set forth in step five clearly met all of the requirements of the Internal Revenue Code of 1954 to qualify as a tax free reorganization under Section 368(a)(1)(A). The mere fact that the six steps transactions and their business purposes were not specifically included in the written plan of reorganization as defined in Section 368 is not a valid reason for totally disregarding the fundamental Federal income tax principles that *it is the substance and not the form of a transaction or series of step transactions which determines Federal income tax consequences*.
>
> Step four was not a separate independent transaction taken for the sole purpose of paying a $419,680 cash dividend to The Christina Corporation. The real substance of step four was to serve as a transitory exchange transaction to effect the statutory merger as described in step five and not for tax avoidance purposes.

Petitioner invokes the step transaction doctrine and urges us to view the six steps outlined above not as separate transactions, but rather, as interdependent steps resulting in a tax-free statutory merger under section 368(a)(1)(A). Petitioner maintains that, if the steps are collapsed, the net result is that petitioner transferred $580,193.36 ($490,000 on July 25, 1966

(step 2) and $90,193.36 on August 2, 1967 (step 6)) to Texas Plastics — $160,513.36 more than the $419,680 petitioner received from Texas Plastics in the transaction at issue — in order to effectuate the merger of Texas Polymer into Texas Plastics; thus, because petitioner transferred $160,512.26 more than it got back, petitioner argues that it cannot have received income, either ordinary or capital gain, in connection with the merger.[9]

We do not think that the step transaction doctrine is available to allow petitioner to escape taxation on its receipt of the $419,680 at issue under the facts of this case. In *Lashar* v. *Commissioner*, 34 B.T.A. 768, 777 (1936), we stated:

> We have held in a number of cases that not every transaction * * * which is provided for in an agreement embodying a plan of reorganization is to be treated for tax purposes as a part of a statutory reorganization. *It is only those transactions which form an essential part of the reorganization that are to be so treated.* * * * [Emphasis added.]

See also *International Telephone & Telegraph* v. *Commissioner*, 77 T.C. 60, 76 (1981), affd. per curiam 704 F.2d 252 (2d Cir. 1983). Petitioners have simply not convinced us that the redemption step was an essential part of the merger of Texas Polymer into Texas Plastics.

Even if we assume that the six steps were taken to permit petitioner to control the surviving Texas Plastics, and that all six steps were part of petitioner's plan of reorganization as contemplated by petitioner, the redemption step, step 4, was

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[9] We note that upon completion of the six steps, petitioner owned 141,369 more shares (115,150 shares received in the merger in exchange for Texas Polymer stock plus 26,219 shares from Texas Plastics' treasury) of the stock of the surviving Texas Plastics than it would otherwise have owned.

not essential to the accomplishment of that objective. At the end of step 3, petitioner owned a controlling interest in Texas Plastics (296,798 of 317,989 shares (excluding treasury stock) or 93.3 percent) and in Texas Polymer (490,000 of 525,000 or 93.3 percent). Had Texas Polymer been merged into Texas Plastics at that point, it is apparent that petitioner would have owned 93.3 percent of the surviving corporation.

Petitioner's explanation of the purpose of the redemption of the 122,000 shares is not convincing. Petitioner states and reiterates that: "Under the Plan of Merger, Texas Plastics, Inc. could only exchange its treasury stock for 525,000 shares of Texas Polymer Corporation common stock owned by The Christina Corporation [petitioner] and F. H. Vahlsing, Sr. if 'no dilution' was to occur." We have examined the plan of merger of Texas Polymer into Texas Plastics, however, and we can find no reference to the redemption by Texas Plastics of any of its stock or to any requirement that petitioner's Texas Polymer shares be exchanged for treasury stock.[10] Nor do we

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[10] The plan of merger states that Texas Plastics is authorized to issue 1,000,000 shares of common stock of which 195,989 are issued and outstanding, not including 149,594 shares held in the treasury. The plan provides:

> The manner and basis of converting the outstanding shares of Polymer into shares of stock of the surviving corporation are as follows: Every share of the capital stock of Polymer issued and outstanding when the merger becomes effective and all rights in respect thereof shall be exchanged for and converted into .235 fully paid and nonassessable shares of the Common Stock, par value $2.00, of the surviving corporation; and each holder of said capital stock of Polymer upon presentation and surrender to the surviving corporation of his stock certificate or certificates shall be entitled to receive in exchange therefor certificates representing shares of the Common Stock of the surviving corporation on the basis herein provided. * * *

The Texas statutes permitted treasury stock to be disposed of by Texas Plastics "for such consideration as may be fixed from time to time by the board of di-

see how, as petitioner emphasizes, an exchange on that basis protected petitioner against dilution of its interest in Texas Plastics. To the contrary, had petitioner retained the 122,000 shares of Texas Plastics stock that were redeemed and, as a result of the merger, received newly issued stock in the surviving corporation for its 490,000 Texas Polymer shares, it would have had 122,000 more shares in the surviving corporation than it did under what petitioner now says was the reorganization plan.

We are not convinced that the real purpose of step four (the redemption by Texas Plastics of the 122,000 shares of its stock) was not to recoup for petitioner some of the cash it had expended in these transactions. Petitioner had only recently paid $490,000 to Texas Plastics for its Polymer stock and $677,682.29 to F. H. Vahlsing, Inc. (Texas) for some Texas Plastics stock. We are not satisfied that the redemption was not used as a means of replenishing petitioner's cash reserve. Otherwise, we have no explanation of either the timing of the redemption or the failure to use unissued stock in the exchange for petitioner's Texas Polymer shares.

In sum, we conclude that the redemption, carried out almost a full year before the merger, must be viewed as a transaction separate from the merger and that it was a transaction which independently gave rise to the tax consequences as determined by respondent.

As to the personal holding company tax determined by respondent, petitioner's only argument in this regard is that —

---

rectors"; par value shares never issued could be disposed of for not less than fair market value. Vernon's Texas Stats. Ann., Bus. Corp. Act, Art. 215A and C. This added flexibility for treasury stock provides no reason for the use of treasury stock to acquire petitioner's Texas Polymer shares becvause the price of $3.44 per share as well as the subsequent public offering price exceeded the $2 par value of the Texas Plastics stock.

> respondent's computation of the percentage of personal holding company income received by the petitioner * * * erroneously includes $419,680.00 of dividend income which is in controversy before the Court on whether the transfer of 122,000 shares of Texas Plastics, Inc. stock * * * was essentially equivalent to a dividend.

Because we have concluded above that the $419,680 is taxable to petitioner as ordinary income, we sustain respondent's determination with respect to the imposition of the personal holding company tax in the absence of any other evidence from petitioner tending to show that respondent's determination is erroneous.

To reflect the foregoing,

Decision will be entered under Rule 155.

Appendix D.

UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT

No. 85-1988.

VAHLSING CHRISTINA CORPORATION,
(FORMERLY THE CHRISTINA CORPORATION),
Petitioner, Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent, Appellee.

JUDGMENT

Entered: July 25, 1986

This cause came on to be submitted on the briefs and original record on appeal from the United States Tax Court.

Upon consideration whereof, It is now here ordered, adjudged and decreed as follows: The decision of the tax court is affirmed.

By the Court:
Francis P. Scigliano
Clerk.

Appendix E.

UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT

No. 85-1988.

VAHLSING CHRISTINA CORPORATION,
(FORMERLY THE CHRISTINA CORPORATION),
Petitioner, Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent, Appellee.

Before
Campbell, *Chief Judge*,
Coffin and Bownes, *Circuit Judges*.

ORDER OF COURT

Entered: August 19, 1986

Upon consideration of appellant's petition for rehearing,
It is ordered that said petition for rehearing be, and the same hereby is, denied.

By the Court:
Francis P. Scigliano
Clerk.

Appendix F.

Supreme Court of the United States

No. A-350

VAHLSING CHRISTINA CORPORATION,

Applicant,

v.

COMMISSIONER OF INTERNAL REVENUE

ORDER EXTENDING TIME TO FILE PETITION FOR WRIT OF CERTIORARI

UPON CONSIDERATION of the application of counsel for the applicant,

IT IS ORDERED that the time for filing a petition for a writ of certiorari in the above-entitled case be, and the same is hereby, extended to and including January 16, 1987.

/s/ William J. Brennan, Jr.
Associate Justice of the Supreme Court
of the United States

Dated this 7th day of November, 1986.

Appendix G.

STATUTES

INTERNAL REVENUE CODE OF 1954

Title 26, United States Code

SEC. 354. EXCHANGES OF STOCK AND SECURITIES IN CERTAIN REORGANIZATIONS.

(a) General Rule. —

(1) In General. — No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

* * * * *

SEC. 361. NONRECOGNITION OF GAIN OR LOSS TO CORPORATIONS.

(a) General Rule. — No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

(b) Exchanges Not Solely in Kind. —

(1) Gain. — if subsection (a) would apply to an exchange but for the fact that the property received in exchange consists not only of stock or securities permitted by subsection (a) to be received without the recognition of gain, but also of other property or money, then —

(A) if the corporation receiving such other property or money distributes it in pursuance of the plan of reorganization, no gain to the corporation shall be recognized from the exchange, but

(B) if the corporation receiving such other property or money does not distribute it in pursuance of the plan of reorganization, the gain, if any, to the corporation shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property so received, which is not so distributed.

(2) Loss. — If subsection (a) would apply to an exchange but for the fact that the property received in exchange consists not only of property permitted by subsection (a) to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

* * * * *

SEC. 368. DEFINITIONS RELATING TO CORPORATE REORGANIZATIONS.

(a) Reorganization. —

(1) In general. — For purposes of parts I and II and this part, the term "reorganization" means —

(A) a statutory merger or consolidation;

* * * * *

Appendix H.

ARTICLES OF MERGER

OF

TEXAS POLYMER CORPORATION
(A DOMESTIC CORPORATION)

INTO

TEXAS PLASTICS, INC.
(A DOMESTIC CORPORATION)

Pursuant to the provisions of Article 5.04 of the Texas Business Corporation Act the undersigned corporations adopt the following Articles of Merger for the purpose of merging them into one of such corporations:

1. The following Plan of Merger was approved by the shareholders of each of the undersigned corporations in the manner prescribed by the Texas Business Corporation Act:

"PLAN OF MERGER

OF

TEXAS POLYMER CORPORATION
(A Texas Corporation)

AND

TEXAS PLASTICS, INC.
(A Texas Corporation)

A. Texas Polymer Corporation ('Polymer') shall be merged with and into Texas Plastics, Inc. ('Plastics') upon the terms and conditions hereinafter set forth. Plastics shall be the surviving corporation.

B. When this merger becomes effective the separate corporate existence of Polymer, except insofar as the same may be continued by statute, shall cease, and the surviving corporation, Plastics, shall thereupon and thereafter possess all the rights, privileges, immunities and franchises, as well of a public as of a private nature, of both Polymer and Plastics; all property, real, personal and mixed, and all debts due on whatever account, including all choses in action, and all and every other interest, of or belonging to or due to Polymer or to Plastics shall be transferred to and vested in said surviving corporation without further act or deed; and said surviving corporation shall thenceforth be responsible and liable for all obligations of Polymer and of Plastics.

C. If at any time the surviving corporation shall deem or be advised that any further assignments or assurances in law or things are necessary or desirable to vest, or to perfect or confirm, of record or otherwise, in the surviving corporation the title to any property acquired or to be acquired by reason of or as a result of the merger provided for by this plan the proper officers and directors of each of the merging corporations shall and will execute and deliver all such proper deeds, assignments and assurances in law and do all things necessary or proper so to vest, perfect or confirm title to such property in the surviving corporation and otherwise to carry out the purpose of this plan.

D. The Articles of Incorporation of Plastics shall be the Articles of Incorporation of the surviving corporation.

E. Until altered, amended or repealed as therein provided, the By-Laws of Plastics as in effect at the time the merger becomes effective shall be the By-Laws of the surviving corporation.

F. The persons who are the directors of Plastics at the time this merger becomes effective shall continue to be the directors of the surviving corporation until the next annual meeting of

the stockholders of the surviving corporation and until their successors are elected and qualify. All persons who are executive or administrative officers of Plastics at the time this merger becomes effective shall be and remain like officers of the surviving corporation.

G. Pursuant to its Articles of Incorporation Plastics is authorized to issue 1,000,000 shares of Common Stock, par value $2.00 per share, of which 195,989 shares are issued and outstanding, not including 149,594 shares held in the Treasury. The issued and outstanding capital stock of Polymer consists of 525,000 shares of Common Stock, par value $1.00 per share.

The shares of capital stock of Plastics, the surviving corporation, issued and outstanding at the time of the merger, are not to be changed or converted as a result of the merger, and each of said shares shall continue to be an issued and outstanding share of the capital stock of the surviving corporation. The manner and basis of converting the outstanding shares of Polymer into shares of stock of the surviving corporation are as follows: Every share of the capital stock of Polymer issued and outstanding when the merger becomes effective and all rights in respect thereof shall be exchanged for and converted into .235 fully paid and non-assessable share of the Common Stock, par value $2.00, of the surviving corporation; and each holder of said capital stock of Polymer upon presentation and surrender to the surviving corporation of his stock certificate or certificates shall be entitled to receive in exchange therefor certificates representing shares of the Common Stock of the surviving corporation on the basis herein provided. Until surrendered each outstanding certificate which prior to the merger becoming effective represented shares of capital stock of Polymer, shall be deemed for all corporate purposes to represent ownership of capital stock of the surviving corporation on the basis herein provided.

Fractional shares and certificates or scrip evidencing the same may be issued by the surviving corporation only to the extent necessary to effectuate the foregoing exchange. Each shareholder of Polymer shall receive certificates for the greatest number of whole shares of the surviving corporation into which his fractional interests can be combined and a certificate or scrip representing a fractional share shall be issued only to evidence a fractional interest remaining after such combination."

2. As to each of the undersigned corporations, the number of shares outstanding and the designation and number of outstanding shares of each class entitled to vote as a class on such Plan, are as follows:

NAME OF CORPORATION	NUMBER OF SHARES OUTSTANDING	ENTITLED TO VOTE AS A CLASS
Texas Plastics, Inc.	195,989 Sh. Common Stock Par Value $2.00	None - no shares other than Common
Texas Polymer Corporation	525,000 Sh. Common Stock $1.00	None - no shares other than Common

NAME OF CORPORATION	TOTAL VOTED FOR	TOTAL VOTED AGAINST
Texas Plastics, Inc.	195,989 Sh.	None
Texas Polymer	525,000 Sh.	None

(continued)

Dated: July 25, 1967

TEXAS PLASTICS, INC.

(SEAL) By /s/_____

F. H. Vahlsing, Jr.,
Executive Vice-President

By /s/_____

Clifford J. Spatz,
Assistant Secretary

TEXAS POLYMER CORPORATION

(SEAL) By /s/_____

F. H. Vahlsing, Jr.
Executive Vice-President

By /s/_____

Joseph Russo,
Secretary

STATE OF NEW JERSEY)
: ss.:
COUNTY OF MERCER)

I, Pearl F. Patterson, a notary public, do hereby certify that on this 25th day of July, 1967, personally appeared before me F. H. VAHLSING, JR., who being by me first duly sworn, declared that he is the Executive Vice-President of Texas Plastics, Inc., that he signed the foregoing document as Executive Vice-President of the corporation, and that the statements therein contained are true.

(NOTARIAL SEAL) /s/Pearl F. Patterson
NOTARY PUBLIC OF NEW JERSEY Notary Public
My Commission Expires
June 23, 1971

STATE OF NEW JERSEY)
: ss.:
COUNTY OF MERCER)

I, Pearl F. Patterson, a notary public, do hereby certify that on this 25th day of July, 1967, personally appeared before me F. H. VAHLSING, JR., who, being by me first duly sworn, declared that he is the Executive Vice-President of Texas Plastics, Inc., that he signed the foregoing document as Executive Vice-President of the corporation, and that the statements therein contained are true.

(NOTARIAL SEAL) /s/Pearl F. Patterson
NOTARY PUBLIC OF NEW JERSEY Notary Public
My Commission Expires
June 23, 1971

Appendix I.

UNITED STATES TAX COURT

In the matter of:	)	
	)	
VAHLSING CHRISTINA CORP.,	)	
Formerly the Christina Corp.,	)	
Petitioner,	)	
Vs.	)	Docket No. 8571-73
	)	
COMMISSIONER OF THE	)	
INTERNAL REVENUE,	)	
Respondent.	)	
	)	

Wednesday,
February 22, 1984
Room 7405
U.S. Courthouse
601 Market Street
Philadelphia, Pennsylvania.

The above entitled matter came on for hearing, pursuant to notice at 1:40 p.m.

BEFORE: HONORABLE C. MOXLEY FEATHERSTON
Trial Judge

APPEARANCES:

On behalf of the Petitioner:
Frederick H. Vahlsing
Vahlsing Services, Inc.
P. O. Box 187
Easton, Maine, 04740

On behalf of the Respondent:
EUGENE J. WIEN, ESQ.
Office of District Counsel
600 Arch Street
Philadelphia, Pennsylvania

EXCERPTS FROM DIRECT TESTIMONY OF FREDERICK H. VAHLSING, JR. (VOL. I. Pages 57-67)

* * *

[57] THE WITNESS: That the only way a million dollars could be sold, the price would have to be reduced to about a dollar a share, and that would mean that the Vahlsing Family ownership of Texas Plastic Stock would be diluted down to about 18 to 20 percent. F. H. Vahlsing, Sr., my father, wasn't even asked — There was no point in even asking him, because there was no way that he would agree to anything of that nature, and as a result the prospectus was failed and pulled.

After it was failed and pulled, there were discussions among the family members, basically myself, my mother and my dad, and it was decided to have a general reorganization, recapitalization, and simplification of these companies, for accounting purposes, tax return purposes, and general good business reasons.

As a result on June — It is part of the stipulation, in June 5, F. H. Vahlsing of Texas sold the Mathis building to Texas Plastics, Inc., sold the 440 long by 110 foot building to Texas Plastics, Inc., at its book value.

[58] THE COURT: That is June 5, 1964?

THE WITNESS: June 5, 1964. Thusly, Texas Plastics, Inc., owned the 440 foot building at Mathis, Texas, where Texas Polymer was conducting its operation. Shortly thereafter, as shown in the stipulation, I believe, Texas Plastics, Inc., sold the Mathis building to Texas Polymer, along with certain machinery and equipment, that had been owned by Texas Plastics and moved from Ellsa, Texas, to Mathis, Texas, in connection with this resin production, for $490,000, and Texas Polymer, Inc., paid Texas Plastics, Inc., 490,000 shares of its

stock of Texas Polymer in payment for the building the machinery, equipment, and some rental debts.

Also at this time, there was a debt owed to F. H. Vahlsing, Sr., my father, of $35,000. Texas Plas — Texas Polymer, excuse me, Texas Polymer issued F. H. Vahlsing, Sr., 35,000 shares of Texas Polymer stock in connection with this transaction.

* * *

[59] On July 25, 1966, F. H. Vahlsing, Inc., owned 197,000 shares of Texas Plastics, Texas Plastics owned 490,000 shares of Texas Polymer. Now, what wanted to be done, what the Vahlsing Family wanted to do, was to merge Texas Polymer into Texas Plastics, and not have any more diultion.

As Mr. Wien has shown on the chart there — On Mr. Wien's chart, that after the merger that objective was accomplished, that Vahlsing Christina Corporation held approximately the same number of shares of Texas Plastics, Inc., before it started these steps in its overall merger, as when it ended all these steps in this overall merger, which was the objective, because it was determined that with the growing of the industry, especially the changing of the bread loaves from paper wrapping to plastic wrapping, the amount of investment in this automated machinery to take thousands of pounds of plastic that is extruded down to 1 mil, 1 ¼ mil, to print it, and make it into bread bags, was a humungous machinery job, and that Texas Plastics needed more money, and [60] in view the prospectus had failed, no money was raised by that, that the Vahlsing Christina Corporation, or Christina Corporation at that time went to Texas Plas — F. H. Vahlsing of Texas and purchased 197,000 shares at $3.40 — $3.44, what we used to call the equivalent exchange ratio, and that little figure was generally put on the bottom right lower hand side of the stock

certificate and if you look at Mr. — at the governments exhibits, you will generally find all of the shares have those figures on the bottom of the shares.

I have the — I am looking at Exhibit, Texas Plastic Inc., stock, 122,000 shares here, which has been stipulated to, right here, Your Honor, and this is what it looks like. Generally all the shares have that. Now, there may have been one or two that got missed along the line, but generally we call that the equivalent exchange ratio, hence, F. H. Vahlsing sold its 197,000 shares of the equivalent exchange ratio of $3.44 which was determined by the last financial ending year of that corporation, that corporation ended June 30, of each year, and if the value of the stock, so many shares were issued and outstanding, and it had a net worth of so much, you divided the shares into that figure, you came up $3.44.

If you had the stock in that particular company. In this particular instance, we are talking about Texas Plastics, Inc. The same — In that way, there was no way we felt that any one could be criticized that this stock was not [61] being transferred at the equivalent exchange ratio that we always talked about, was at the book value at the last annual report.

Christina laid out to F. H. Vahlsing of Texas, 197,000 times — 197,000 times 3.44, which equals in that transaction $677,680.00.

THE COURT: Now that went to —

THE WITNESS: F. H. Vahlsing, Inc. of Texas.

THE COURT: Of Texas?

THE WITNESS: Yes, sir. In the same board minutes, which is part of the stipulation, on that same day, Christina purchased from Texas Plastics, Inc., 490,000 shares of Texas Polymer, at $1.00 a share. Equivalent exchange ratio was $1.00 a share. It was 99 and some cents on the books, so it was made a $1.00 a share, and I remember that, they called it a dollar a share. It was $490,000.

So Christina was obligated to pay out on the equivalent exchange ratio, $490,000. Now that is a total of $490,000, plus 4-9-0-0-0-0, that now has Christina — How much is it — I hit the wrong number, sorry. $1,167,680.00 that Christina was obligated to pay out. Now that was on approximately July 25, 1966, the exact date is on the stipulation.

THE COURT: All right $677,000 went to —

THE WITNESS: F. H. Vahlsing, Inc., of Texas.

THE COURT: And $490,000 went to —

[62] THE WITNESS: Went to Texas Plastics —

THE COURT: Texas Plastics?

THE WITNESS: That's correct. That's right, and no one on that exact date, knew where each of these company's balances stood, because Texas Plastics was selling packaging supplies to Christina, which is all F. H. Vahlsing of Maine, they were doing the trucking, they were doing all types of things in those days. Thirty days later, on August 29, 1966, same year, thirty days later, Christina sold to Texas Plastics 122,000 shares at the equivalent exchange ratio of the same price, $3.44 a share.

THE COURT: Sold it to whom, now?

THE WITNESS: Texas Plastics, Inc.

THE COURT: Its own stock?

THE WITNESS: Its own stock, yes, sir, to be put into its treasury, as set forth in the minutes, and which was argued yesterday in the stipulation.

THE COURT: That is how much now?

THE WITNESS: And that is the $419,680, and at this time, I would like to introduce the check as Petitioner's Exhibit 1, for $419,680 —

THE COURT: Now, is this — Let me ask you, is there any dispute as to whether this $419,000 passed from Christina to Texas Plastics, Inc.?

MR. WIEN: No, sir.

[63] THE COURT: Then the check is not necessary.

THE WITNESS: Is there any dispute that Texas Plastics didn't have any money in the bank?

MR. WIEN: That I have no way of knowing.

THE COURT: Hand the Exhibit to Mr. Wien, and let him take a look at it and we will mark it as an Exhibit.

MR. WIEN: I don't know that that shows that they didn't have any money in the bank.

THE WITNESS: All right, well they had $4,235 —

* * *

THE WITNESS: I was the signatory on this account say, and I will state under oath that this bank statement is accurate. This was the check that we didn't put in, with my signature on it, when I had my arm, and this is the bank statement —

THE COURT: Hand it to the clerk.

THE WITNESS: — from the Chase Manhattan Bank.

THE COURT: All right, now the point that you made [64] here in this respect that Texas Plastics, Inc., at that time had $2,000 in the bank account only.

THE WITNESS: Well, — no, it started out with $4200, I believe, Your Honor.

THE COURT: It started out with $420,000.

THE WITNESS: No, no, no, no. The top, $4,200 and some dollars, sir.

THE COURT: All right.

THE WITNESS: And the $420,000 came from Christina, it was a payment from Christina on account of the 490,000 shares of Polymer stock which it purchased, which Texas Plastics turned around and paid back to Christina, the 419, which left $320.00 in the bank to Plastics, as a result of those transactions.

* * *

[65] THE WITNESS: the $420,000, Your Honor, came from Vahlsing Christina, so that Texas Plastics could pay — could pay Vahlsing Christina the $419,680, because the equivalent exchange ratio wanted to be documented and not on a general account, in view of the fact that Texas Plastics was going to go public, and some person might have asked questions what was the price of those shares in connection with the merger.

Well, basically, there was $320.00 that Texas Plastics ended up receiving in this transaction, receiving, not paying out, $320.00. Plus Vahlsing Christina had to pay Texas Plastics at sometime in the next three or four months, an additional $70,000, because it owed Texas Plastics $490,000 [66] for the Polymer purchase, which it did. So, thus the account that Christina paid out, in order to protect its dilution, is now up to $1,167,680, plus $70,000, which is — I have the wrong thing, how much is it. All right, $1,167,680.00 that Christina had laid out.

* * *

THE WITNESS: On July 31, 1967, the merger of Texas Polymer into Texas Plastics is accomplished. And Christina gets back in connection with such merger, after laying out the $1,167,680, gets back 115,150 shares, which is the 490,000 shares of Polymer, times .235, and I will check that to make sure that is right. 490,000 shares times .235 equals 115,150.

So Texas Plastics gets back 115,100 — I mean Vahlsing Christina gets back 115,150 shares, but is stated on the previous exhibits, true, but he said there is no difference in the stock ownership, but Christina has laid out of its pocket $1,167,680, this did not dent to Christina, Christina has laid it out.

Now, two days after the close of Texas Plastics fiscal year, on July 31, 1967, Christina lays out another $90,000, and change, which is part of the stipulation, which now makes it

Christina has laid out $1,257,000 and change in order to protect its dilution factor, because they felt that this prospectus is going to go.

[67] The new prospectus was filed a short time later. Sometime in — And the new prospectus, and prior to the filing of the new prospectus it was in October, I think, Your Honor, something, 68, — The Texas Plastic shares were split two for one, and the new prospectus came out — it is in the stipulation, sir. Was split two for one, and the stock came out at $6.00 a share, or in other words, or really $12.00 a share of the 1962 prospectus, four times as much on the price per share, after the merger and was raised $3 million dollars successfully oversold, probably double, and money collected on February 20, 1969, and this is the final prospectus that I would like to put in evidence.

* * * * *

FILED
MAY 1
JOSEPH F. SPANIOL, JR.

No. 86-1201

In the Supreme Court of the United States

OCTOBER TERM, 1986

VAHLSING CHRISTINA CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

CHARLES FRIED
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

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In the Supreme Court of the United States

OCTOBER TERM, 1986

No. 86-1201

VAHLSING CHRISTINA CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

Petitioner contends that its receipt of cash upon redeeming stock it held in Texas Plastics, Inc., should have been treated as a tax-free component of a corporate reorganization, rather than as the occasion for the realization of taxable income.

1. Petitioner is one of several corporations that were owned by members of the Vahlsing family. In the mid-1960s, the Vahlsing family decided to reduce the number of corporations through which it conducted its various businesses. As of July 25, 1966, petitioner directly owned 31.4% of the 317,989 outstanding shares of stock of Texas Plastics, Inc. On that date, petitioner purchased from one of its wholly-owned subsidiaries, F.H. Vahlsing, Inc. (Texas), an additional 197,000 shares of Texas Plastics stock at a price of $677,682. That gave petitioner a 93.3% interest in Texas Plastics. At the same time, petitioner purchased from Texas Plastics 490,000 shares of stock in Texas Polymer Corp., another Vahlsing family company, at a price of $490,000. That gave petitioner a 93.3% interest in Texas Polymer. Pet. App. 8a-12a.

On August 29, 1966, in the transaction whose tax consequences are at issue here, Texas Plastics paid petitioner $419,680 in redemption of 122,000 of petitioner's shares of Texas Plastics stock. That reduced petitioner's interest in Texas Plastics from 93.3% to 89.2% (Pet. App. 10a). In June 1967, F.H. Vahlsing, Inc. (Texas) was merged into petitioner. In July 1967, Texas Polymer was merged into Texas Plastics. Pet. App. 8a-12a.

The Commissioner determined that the cash received by petitioner upon the August 29, 1966, redemption of the Texas Plastics stock gave rise to dividend income on petitioner's part pursuant to Sections 301 and 302 of the Internal Revenue Code.[1] As a result of realizing that dividend income, petitioner became a "personal holding company" (see I.R.C. § 542) for the taxable year ending June 30, 1967. Petitioner therefore became liable for the personal holding company tax imposed by Section 541 of the Code. Pet. App. 7a-8a.

2. Petitioner sought redetermination of the resulting deficiencies in the Tax Court, which upheld the Commissioner's position that petitioner was liable for the personal holding company tax (Pet. App. 7a-25a). The Tax Court concluded that the redemption had resulted in no meaningful reduction in petitioner's percentage of ownership of Texas Plastics and that it therefore was "essentially equivalent to a dividend" within the meaning of Section 302(b)(1) of the Code (Pet. App. 18a). See *United States* v. *Davis*, 397 U.S. 301 (1970). The court also stated that the redemption could not be viewed as an essential step in an integrated corporate reorganization, finding it more likely that the redemption was undertaken to replenish petitioner's cash reserves (Pet. App. 24a). The Tax Court accordingly concluded that "the redemption, carried out almost a full year before the merger, must be viewed as a

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[1] Unless otherwise noted, all statutory references are to the Internal Revenue Code (26 U.S.C.), as amended (the Code or I.R.C.).

transaction separate from the merger and that it was a transaction which independently gave rise to the tax consequences as determined by [the Commissioner]" (*ibid.*).

Subsequently, the Tax Court denied a motion for reconsideration filed by petitioner (C.A. App. 41-42). The court stated there that, even if it were to accept petitioner's claim that the redemption was in pursuance of a plan of reorganization, petitioner's receipt of the $419,680 would not escape recognition under Section 354 of the Code, as petitioner claimed. The court noted that Section 354 applies only to exchanges of "stock or securities" pursuant to a plan of reorganization, whereas petitioner exchanged stock in Texas Plastics for $419,680 in cash. The court therefore concluded that, if the $419,680 were not taxable as a dividend under Section 302(b)(1), it would be taxable as a dividend under Section 356 of the Code (C.A. App. 41).

The court of appeals unanimously affirmed in an unpublished opinion (Pet. App. 1a-4a). The court held that the cash petitioner received on the redemption of its Texas Plastics stock was subject to tax even if, as petitioner maintained, the redemption were considered a necessary step in a corporate reorganization (*id.* at 2a).[2] The court noted that Section 354 of the Code limits nonrecognition of gain in a corporate reorganization to exchanges of stock or securities for other stock or securities and does not extend to exchanges of stock for cash (Pet. App. 2a). The court further observed (*id.* at 3a-4a) that petitioner had cited no authority to support collapsing the various Vahlsing maneuvers and "allow[ing] the elevation of substance over form with regard to" the cash-for-stock transaction.

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[2] The court of appeals therefore found no need to address the Tax Court's alternative holding that the $419,680 was taxable to petitioner under the redemption provisions because the redemption was not a "necessary" part of the reorganization (Pet. App. 2a n.1).

The court therefore concluded that the outcome was governed by this Court's injunction that, " 'while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not * * * and may not enjoy the benefit of some other route he might have chosen to follow but did not.' *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974)."

3. Petitioner contends (Pet. 10-13) that the Commissioner was bound to ignore, for income tax purposes, the cash payment received upon the redemption of the Texas Plastics stock because that payment "was an interim transitory step in a reorganization transaction." There are a number of threshold problems with this contention. First, it is by no means clear that a taxpayer who has deliberately chosen to structure a transaction in a particular way may invoke the "step transaction" doctrine in an effort to avoid the adverse tax consequences that attend the form he has chosen. Second, it is by no means clear that the several transactions undertaken by the various Vahlsing corporations added up to a "reorganization" as defined in Section 368.[3] Third, even if petitioner did participate in a "reorganization," it is by no means clear that the redemption at issue, which preceded the merger by a year, should be treated as part of the "plan of reorganization." Fourth, even if the redemption were viewed as part of the "plan of reorganization," it is by no means clear that it was a necessary part, since, as the Tax Court pointed out (Pet. App. 23a), there was no reason why Texas Polymer could not have been merged into Texas Plastics *before* the re-

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[3] Petitioner relied on various subsections of Section 368 at trial. See Pet. App. 18a & n.7.

demption, at which point petitioner conveniently owned identical 93.3% interests in each subsidiary.[4]

In any event, even if one assumes that petitioner could surmount all of these threshold obstacles, the court of appeals was clearly correct in holding that there would still be no basis for treating petitioner's receipt of the $419,680 as a nontaxable event. The nonrecognition afforded reorganizations by Section 354(a)(1) of the Code extends only to "stock or securities" received in exchange for "stock or securities." Section 356(a)(1) of the Code provides that if, in connection with a corporate reorganization, a shareholder receives stock in a corporation that is a party to the reorganization and also "other property or money," the shareholder must recognize the gain realized in the transaction in an amount not in excess of the value of that money or other property. Accordingly, as the court of appeals held, there is no basis upon which the cash received by petitioner for the redemption of its Texas Plastics stock may escape taxation.[5]

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[4] Petitioner contends (Pet. 13-15) that the redemption did not need to be a "necessary" step in the reorganization in order for the "step transaction doctrine" to apply. As petitioner itself acknowledges (Pet. 13), however, the court of appeals explicitly did not reach this issue. Rather, it assumed that the redemption was a necessary step in the reorganization (Pet. App. 2a n.1), and therefore it expressed no view on whether petitioner's contention would be foreclosed if the redemption were not "necessary." This case accordingly presents no occasion to decide whether a step must be a "necessary" one in order for the "step transaction" doctrine to apply.

[5] Neither Section 354 nor Section 356 applies unless the transaction qualifies as a "reorganization" under one of the subsections of Section 368(a). *Turnbow* v. *Commissioner*, 368 U.S. 337 (1961). If the redemption in question was not part of a reorganization, as the Tax Court concluded, the treatment of the proceeds received in the redemption would be governed by Section 302 of the Code. See generally *Shimberg* v. *United States*, 577 F.2d 283 (5th Cir. 1978), cert. denied, 439 U.S. 1115 (1979). And, as the Tax Court demonstrated (Pet. App. 15a-16a), the amount received by petitioner

Petitioner's assertion (Pet. 12) that the decision below conflicts with other decisions applying the "step transaction doctrine"—namely, *Helvering* v. *Limestone Co.*, 315 U.S. 179 (1942); *McDonald's Restaurants* v. *Commissioner*, 688 F.2d 520 (7th Cir. 1982); and *King Enterprises, Inc.* v. *United States*, 418 F.2d 511 (Ct. Cl. 1969)—is wholly without merit. None of those cases remotely suggests that, contrary to the express terms of the Code, cash received in connection with a reorganization need not be recognized. Indeed, *King Enterprises* specifically held that the cash and promissory notes received in the reorganizations at issue there were to be treated as a dividend under Section 356. See 418 F.2d at 519-521.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

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Solicitor General

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would be taxable as a dividend under Section 302—a conclusion that petitioner does not contest—because the redemption reduced petitioner's interest in Texas Plastics only from 93.3% to 89.2%, a reduction that obviously could not be characterized as "meaningful." See I.R.C. § 302(b)(1). On the other hand, if the redemption here was a part of a reorganization within the meaning of Section 368(a), as petitioner maintains and as the court of appeals assumed arguendo, the treatment of the redemption proceeds is governed by Section 356(a) of the Code. Under that provision, if the redemption had the effect of the distribution of a dividend, then the amount received by petitioner (to the extent of the gain realized) is taxed as a dividend. See *Shimberg* v. *United States*, *supra*. Petitioner makes no contention that the $419,680 it received was entitled to capital gain treatment, nor does it claim that its gain was less than the amount it received from the redemption. Rather, it flatly asserts that it need not recognize any income with respect to the redemption—an assertion that flies in the face of the express terms of Section 356.